

Congress and Financial Crises

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The four case studies of congressional response during financial crises described in this report (events from the 1840s and the 1890s, as well as the Great Depression and the 2008 financial crisis) illustrate key characteristics of the policymaking process. Most importantly, when financial crises happen, Congress' hands are neither tied nor forced by policies and institutions put in place by previous Congresses. In the 2008 example, Congress proves able to pass far-reaching legislation, even though significant automatic response mechanisms like the Federal Reserve were already in place. Many of the temporary programs and policies adopted in response to the mortgage crisis had analogous temporary measures during prior crises.

Introduction

In September 2008, the Secretary of the Treasury and the chairman of the Federal Reserve asked Congress for \$700 billion to combat the financial crisis, asserting that the economy would collapse if Congress failed to act. Following the crisis, Congress passed legislation that granted powers to financial regulatory agencies intended to enable them to handle future crises without a similar request being made to Congress. The law included provisions designed to end market perceptions of too-big-to-fail (TBTF)—i.e., that because everyone knows that the negative repercussions of a firm's failure are not tolerable, the government must provide financial assistance to the firm if it gets in trouble.

This report analyzes Congress during a financial crisis, with special emphasis on whether the existing regulatory framework (passed by a previous Congress) either ties Congress' hands or forces congressional action. Case studies of four financial crises—with examples of both congressional action and inaction—illustrate congressional discretion to change the rules of the game during financial crises. Because people often want temporary suspensions of the rules of the game during a crisis, preexisting rules are unlikely

to be effective at either tying Congress' hands or forcing congressional action.

This is a report about economic crisis response, not crisis prevention. Crisis prevention is relevant only to the extent that it is an integral part of the rules that exist prior to the start of whatever crisis Congress finds itself in. During an economic crisis, policy-makers consider temporarily suspending some laws and creating one-time assistance programs. But even if Congress does nothing in response, the existing laws and programs continue to govern the outcome—in contrast to some other issues in which Congress must take periodic action to preserve the status quo (budgets and program reauthorizations, for example).

People sometimes want one set of rules for standard conditions but a different set of rules for unusual conditions. For example, after Hurricanes Katrina and Rita wiped out communications and records in several States, some agencies temporarily suspended certain paperwork requirements related to refinancing mortgages.¹ A financial crisis often has calls for similar suspensions of existing rules and policies or pleas for temporary one-time assistance to targeted groups. This report will examine economic policies considered by Congress during the containment phase of financial crises.

At the time a financial crisis begins, most rules and agency authorities are a legacy of previous legislation. In constructing the economic rules of the game and authorizing agencies that administer economic policy, Congress and the President have typically consulted the leading economists of the day.² Furthermore, many of the economic agencies were created following earlier financial crises and staffed by professional economists and lawyers. Yet during a financial crisis, people may still see some of the features of the existing economic policy framework as a hindrance (perhaps temporarily) rather than a help.

It is no criticism of economists to point out that despite their input at the rule-setting stage and in the administration of existing rules, bad economic events still happen. This report is not about identifying the correct set of economic policies according to current experts, because those rules (whatever they are at any given point in time) will most likely be subject to calls for suspension, alteration, or fundamental change. This report examines what economic policy issues have regularly come before Congress during financial panics, recessions, and depressions. This report does not address whether Congress could in various instances have done better.

CONGRESS AND ECONOMIC POLICY

Title I of the Constitution grants Congress a number of powers related to the economy:³

¹U.S. Department of Housing and Urban Development, *Public and Indian Housing Hurricane Recovery Resources*, at http://portal.hud.gov/hudportal/HUD?src=/program_offices/public_indian_housing/publications/hurricane.

²For example, Congress established a National Monetary Commission following the panic of 1907. The commission was led by and staffed with prominent economists. The Federal Reserve Act followed many of the commission's recommendations. Congress created commissions to investigate the causes of the Great Depression and the 2007–2008 recession.

³The report will at times refer to congressional powers pursuant to Title I of the Constitution. Such powers depend upon actions by the executive and judicial branch as appropriate.

- To spend money, levy taxes, and borrow funds,
- To define currency and regulate its value,
- To regulate banks,
- To establish rules for bankruptcy, and
- To regulate interstate commerce.

The first two powers loosely correspond to macroeconomic policies (fiscal policy and monetary policy). The others are microeconomic policies that some believe can have macroeconomic effects (financial market intervention, debt restructuring, and industrial policy).

At any moment in time, the economy operates within a legal framework created by Congress, including rules and policies adopted by agencies to which Congress has delegated authority. For example, in the area of monetary policy, Congress has sometimes legislated the value of currency in terms of gold but has delegated to the Federal Reserve authority to affect the supply of obligations circulating as gold-backed currency. At other times, Congress has set the value of a dollar in terms of either gold or silver and has not delegated authority to regulate the supply of related obligations to any agency. Currently, there is no established value of the dollar, and Congress has delegated to the Federal Reserve authority to issue the notes circulating as dollars. In policy areas where Congress has delegated some of its authority, Congress oversees the actions of the agencies and can revise the delegated authority.

An economic emergency typically results in calls for changes in the existing economic policy framework. People may wish Congress to facilitate expansion of the money supply (“easy money”), to restore “sound money,” or either to grant further discretion to the monetary authority or to clip its wings. People may call upon Congress to increase Federal spending and cut taxes, or Congress may be called upon to restore fiscal discipline and protect the creditworthiness of the United States. Congress may be asked to rescue banks, suspend banking operations, or facilitate the liquidation of distressed banks. Congress may be called upon to enact a mortgage moratorium, delay debt collection, or strengthen the ability of creditors to collect debts owed. Congress may be called upon to provide financial support to specific industries or to regulate some industries more stringently.

Even if Congress does not change the fundamental economic rules, it still oversees the effectiveness of existing programs to address the economy during a financial crisis. For example, in addition to general monetary policy, the Federal Reserve is empowered to provide emergency lending to eligible borrowers based upon good collateral. During the crisis of 2008, the Federal Reserve established temporary programs to provide loans using a wider variety of collateral and to a wider variety of potential borrowers than it allows during normal times. Congress held numerous hearings in 2008 in which the Federal Reserve and other agencies were required to report on their activities, including the Federal Reserve’s temporary liquidity programs.

ECONOMIC HARDSHIP AND ECONOMIC CRISIS

It may be useful to distinguish recessions and depressions from financial crises. A common quip is that a recession is when someone else loses his or her job, but a depression is when I lose my own job. A recession occurs when a broad range of economic indicators contract.⁴ A period of economic hardship may include more than one technical recession.⁵ A second downturn may occur before a nascent recovery can return an economy to full capacity. The United States has experienced several periods of high unemployment that have spanned multiple recessions and recoveries. The Great Depression is commonly dated from 1929 to 1941, even though the period 1933–1937 was technically a recovery, not a recession. Similarly, both the depression of the 1890s and the hardship of the early 1980s included double-dip recessions before full employment could be restored.⁶ The recession that began in December 2007 officially ended in June 2009, even though unemployment has remained above full employment for more than 5 years, leading to the moniker the Great Recession.⁷

A financial crisis is a widespread financial disruption characterized by falling asset prices, bankruptcies, insolvencies, and illiquidity. It may or may not precede or accompany a recession or depression. A financial crisis often includes sharp declines in asset prices (e.g., Dutch tulip bulbs in 1637), the sudden collapse of security prices (e.g., common stock), widespread suspensions of payments by key intermediaries (e.g., depository banks), or the failure of key providers of financial services. The uncertainty and chaos created during these sudden financial crises are called a panic. Some panics are followed by deep recessions (2008) or even depressions (1893, 1933). Others are not (1987, 1888).⁸

Periodic economic hardship has been common in U.S. history. There were extended periods of economic hardship in the late 1830s and early 1840s, the 1870s, and the 1890s. Since the establishment of the Federal Reserve in 1914, extended periods of economic weakness occurred in the 1930s, the late 1970s/early 1980s, and the 2000s. Notable market crashes, financial panics, or bank runs include those of 1837, 1839, 1857, 1873, 1893, 1907, 1929, 1931, 1933, 1987, and 2008.⁹

⁴The National Bureau of Economic Research (NBER) is considered the official arbiter of the dates of recessions and expansions. NBER tracks a variety of economic indicators and identifies peaks and troughs in business activity. Recessions last from a peak down to a trough. However, to the common person, the economic hardship associated with being near a trough may feel like a depression, even though it is technically not a recession. Dates and related information can be found at <http://www.nber.org/cycles/cyclesmain.html>.

⁵National Bureau of Economic Research, *U.S. Business Cycle Expansions and Contractions*, <http://www.nber.org/cycles/cyclesmain.html>.

⁶Douglas Steeples and David Whitten, *Democracy in Desperation: The Depression of 1893* (Westport, CT: Greenwood Press, 1998).

⁷See, e.g., Stanley Fischer, "The Great Recession: Moving Ahead," at <http://www.federalreserve.gov/newsevents/speech/fischer20140811a.htm>.

⁸Bradford J. DeLong and Lawrence H. Summers, "The Changing Cyclical Variability of Economic Activity in the United States," in *The American Business Cycle: Continuity and Change*, ed. R.J. Gordon (Chicago: University of Chicago Press, 1986), pp. 679–719.

⁹Michael D. Bordo et al., "Is the Crisis Problem Growing More Severe?" *Economic Policy*, vol. 16 (August 2001), pp. 51–82. The dates and number of banking panics in the United States are sensitive to the definition used. Contemporaries often called a financial disruption a panic. Various attempts to identify panic dates with objective measures of asset prices have generally confirmed crises in 1837, 1839, 1857, 1873, 1893, 1907, and 1930. Other dates often depend on the measure used. See Gary Gorton, "Banking Panics and Business Cycles," *Oxford Economic Papers*, vol. 40 (1988), pp. 751–781.

During a financial panic, no one can know for certain if it will be followed by a recession or depression or have no effect. The credibility of experts, such as prominent economists, is likely to be tarnished at the same time that the panic hits, in part because it is likely that many of these experts contributed to the feeling of confidence in existing tools prior to the crisis. For example, many economists at the International Monetary Fund, the Federal Reserve, academia, and elsewhere believed that macroeconomic advances had created a Great Moderation among developed economies, perhaps contributing to overconfidence following the liquidity crunch that began in August 2007.¹⁰ Similar confidence in macroeconomic tools was expressed following Federal Reserve responses to recessions in the 1920s.¹¹ Following the stock market crash of 1929, Irving Fisher, one of the greatest American economists of his generation, famously proclaimed the economy sound, damaging his reputation and personal fortune in the process.¹² The point is not that economists are fallible like anyone else but that, in some cases, market prices are moving differently than experts predict or explain—which might be why there is a panic—which tends to diminish the credibility of these experts when they testify before or advise Congress.

The next section of this report connects congressional authorities to economic policies during financial crises. For each policy area, the section describes what it is in economic terms and briefly provides congressional context.

Congressional Policy Tools

MONETARY POLICY

Economists define money as relatively safe assets that people rely upon to make payments or to hold as a short-term investment, i.e., liquidity.¹³ Monetary policy refers to actions taken to alter the money supply with the intent of influencing macroeconomic conditions, including real output, unemployment, and inflation.¹⁴ Congress has affected the money supply by redefining money to include a broader or narrower array of commodities (or none at all), revising or abandoning the ratio of current commodities to the dollar, creating obligations that others can use as collateral for issuing moneylike instruments, and regulating the ability of banks to maintain moneylike deposit or similar accounts on behalf of customers or investors. Congress delegated much of day-to-day monetary policy to the Federal Reserve. Currently, paper money is issued by the Federal Reserve.

¹⁰For an example of a central bank official noting reduced macroeconomic volatility, see Ben S. Bernanke, “The Great Moderation,” at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040220/>.

¹¹For an introduction to the role of expectations in the macroeconomy, see Sylvain Leduc, “Confidence and the Business Cycle,” FRBSF Economic Letter, November 2010, at <http://www.frbsf.org/economic-research/publications/economic-letter/2010/november/confidence-business-cycle/>.

¹²Robert Loring Allen, *Irving Fisher: A Biography* (Cambridge, MA: Blackwell, 1993).

¹³Board of Governors of the Federal Reserve System, *What Is the Money Supply? Is It Important?* at http://www.federalreserve.gov/faqs/money_12845.htm.

¹⁴David Lindsey and Henry Wallich, *Money: New Palgrave Dictionary of Economics* (New York: Norton, 1987), pp. 229–243.

For some economists, monetary conditions are the heart of most financial crises. In their research on U.S. monetary history, Milton Friedman and Anna J. Schwartz noted that what distinguished depressions from recessions was the magnitude of the contraction of the money supply.¹⁵ More recently, scholars have emphasized that during the Great Depression of the 1930s, economies remained depressed as long as they had tight money policies and adhered to the gold standard but that recovery generally accelerated when countries abandoned gold and “reflated.” The United States devalued the dollar in terms of gold in 1933, and many economists believe that devaluation contributed to recovery.

Unanticipated deflation can increase the real burden of debts. Such burdens may not be fully offset by gains to creditors if there are widespread defaults. Increasing the money supply may alleviate deflation. But one should not assume that these economists believe that only the absolute quantity of money matters. Rather, as economist Michael Bordo put it, “it is not monetary contraction but the public’s apprehension that the availability of the means of payment is in doubt. That is the essence of the monetarist position.”¹⁶ Furthermore, there may be conditions in which monetary policy becomes ineffective.

FISCAL POLICY

Fiscal policy is the government’s actions to influence the macroeconomy by adjusting government spending and revenue.¹⁷ In particular, when there is underutilized productive capacity, such as in a recession, government can stimulate the economy by increasing budget deficits through spending more or taxing less.¹⁸ Fiscal policy has an automatic component because bad economic conditions reduce tax receipts and trigger increased spending on some programs even if Congress takes no action. For example, during the Great Depression, the largest contributor to Federal deficits was the automatic drop in revenue, not any action pursued by policymakers. In the view of modern economists, even the drop in revenues during the Great Depression was too small relative to the economy to have any meaningful effect.

Federalism affects American fiscal policy. During some parts of the 19th century, State borrowing for development projects was expansionary, but fiscal surpluses at the Federal level were contractionary. Now that balanced budget requirements are the norm for States, expansionary Federal fiscal policy may be offset by tight State policies.¹⁹ Alternatively, Federal grants to States may help States avoid contractionary policies.

¹⁵ Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States: 1867–1960* (Princeton, NJ: Princeton University Press, 1963).

¹⁶ Michael D. Bordo, “Discussion: The Panic of 1873 and Financial Market Volatility and Panics before 1914,” in *Crashes and Panics: Lessons from History*, ed. Eugene N. White (Homewood, IL: Irwin, 1990), p. 128.

¹⁷ The most general constitutional provisions authorize Congress to tax, borrow, and spend (Article I, Section 8, Clauses 1 and 2, and Section 9, Clause 7).

¹⁸ CRS Report RL33657, *Running Deficits: Positives and Pitfalls*, by D. Andrew Austin, and U.S. Congressional Budget Office, *The Long-Term Budget Outlook: July 2014*, <http://www.cbo.gov/sites/default/files/cbofiles/attachments/45471-Long-TermBudgetOutlook.pdf>.

¹⁹ Leslie McGranahan and Jacob Berman, “Measuring Fiscal Impetus: The Great Recession,” *Economic Perspectives* (Third Quarter 2014), pp. 67–79, at http://www.chicagofed.org/digital_assets/publications/economic_perspectives/2014/3Q2014_part1_mcgranahan_berman.pdf.

BANKRUPTCY LAW AND DEBT RESTRUCTURING

Financial crises and depressions typically include widespread debt defaults and declines in asset prices. Policymakers may wish to provide relief to people facing foreclosure and eviction. In addition to compassion for individuals, bankruptcy policy may have macroeconomic effects. Some economists believe that defaulting on debt can result in a balance sheet recession in which distressed households cut consumption, firms cut investment, and local governments cut spending in order to repair balance sheets damaged by declines in the price of assets.²⁰ As each sector tries to reduce its net debt (de-leverage), total economic spending declines, potentially magnifying the economic contraction.²¹

Bankruptcy laws may affect balance sheet recessions and the macroeconomy.²² People who are in default are often cut off from further credit because they are considered riskier borrowers. If so, then monetary policies that lower interest rates may not stimulate their consumption or investment. People who hold bonds similar to those defaulting may find it difficult to use their bonds as collateral for additional funds even if the specific bonds they are holding are not currently in default. Bankruptcy law may affect the speed in which distressed debt is resolved. Bankruptcy law may affect whether debtors who have defaulted get a fresh start and may begin spending on new produced goods and services if they have earnings—or if they would be required to pay old debts instead.

BANKING REGULATION AND FINANCIAL MARKET INTERVENTION

Financial intervention refers to steps taken to stabilize the function of banks, which may include rescuing financial institutions from failure. Banks are the hubs of the payment system, meaning that many retail and commercial transactions are conducted by communications among deposit-taking financial institutions. The fractional reserve structure of depository institutions means that they also affect the money supply. When banks come under stress, they reduce their own lending, which reduces the money supply. Unfortunately, in the aggregate, this contraction in lending may come exactly when bank customers most need additional short-term financing.²³ Banking regulation and financial market intervention refer to steps taken to ensure the continued functioning of the payment system and lending systems during a financial crisis and depression.

Financial crises are challenging for banks and other financial intermediaries.²⁴ If debtors are defaulting, then their lenders have an interruption in cash flow. If the banks and other intermediaries that provided the loans hold assets that are difficult to liquidate or

²⁰ Marcus Miller and Joseph Stiglitz, "Leverage and Asset Bubbles: Averting Armageddon with Chapter 11?" *Economic Journal*, vol. 120, no. 544 (May 2005), pp. 500–518.

²¹ Enrique G. Mendoza, "Lessons from the Debt-Deflation Theory of Sudden Stops," *American Economic Review*, vol. 96, no. 2, (May 2006), pp. 411–416.

²² David Smith and Per Stromberg, "Maximizing the Value of Distressed Assets: Bankruptcy Law and the Efficient Reorganization of Firms," *Systemic Financial Crises*, ed. Patrick Honohan and Luc Laeven (Cambridge: Cambridge University Press, 2005).

²³ Douglas Diamond and Philip Dybvig, "Bank Runs, Deposit Insurance, and Liquidity," *Quarterly Review* (winter 2000), at <http://www.minneapolisfed.org/research/qr/qr2411.pdf>.

²⁴ Jean Tirole, *Illiquidity and All Its Friends*, Bank for International Settlements, Working Papers No. 303, March 2010, at <http://www.bis.org/publ/work303.htm>.

became difficult to sell because of the crisis, then they will have difficulty honoring their own obligations. Since deposit accounts are bank obligations, financial crises often put stress on the depository system. Similar stress can be put on other transaction services provided by nondepositories. If people lose confidence in banks, they may withdraw their funds, endangering the health of the banks and potentially reducing the money supply by a multiple of the withdrawn funds.

Congressional Policies During Selected Financial Crises

This section provides illustrative examples of challenges to the economic rules of the game during selected financial crises and depressions. A discussion of multiple policy areas is provided only for the Great Depression and the Great Recession. Selected cases are presented to illustrate the policy issues repeatedly brought before Congress during times of economic stress. Congress retains the ability to change the fundamental rules of the economic game and has been called to do so during financial crises. Whether Congress might have made a different decision in light of current economic thought is not the focus of this report.

The history is not provided to reveal a steady march toward economic enlightenment or a painstaking erection of macroeconomic safeguards; rather, the history demonstrates that Congress retains the authority to suspend or fundamentally change the economic rules of the game and will likely be called upon to do so in times of crisis, and its actions or inactions may ameliorate or prolong economic turmoil. Powers delegated to the Federal Reserve and other agencies can be expanded, amended, or rescinded. Similarly, whatever monetary standard Congress had established prior to the crisis can be strengthened, supplemented, or abandoned. If congressional deliberations create uncertainty and concern over future actions, the debate itself may contribute to temporary instability regardless of the ultimate vote.

THE DEPRESSION OF THE 1840S

ECONOMIC AND INSTITUTIONAL CONTEXT

Monetary policy, fiscal policy, the structure of the banking system, and bankruptcy law were all major issues during the 1840s, but this section will focus primarily on congressional influence over fiscal federalism. This case study illustrates continued congressional discretion in the face of TBTF. Congress faced an economic crisis in which State governments were defaulting on some of their debts. Congress considered intervening on behalf of State debt and established a commission to study the issue in great detail. Despite the commission's recommendation that State governments be assisted, Congress chose not to do so. Not only did Congress not pass financial assistance to the States, but it did pass legislation designed to prevent the executive branch from using the treaty process to assist foreign holders of State debt. The TBTF status of the States did not force Congress' hands.

After a boom and bust in canal and railroad building, there were financial panics in 1837 and 1839. Economic problems persisted

long after the panics.²⁵ Land and agricultural prices declined, making it difficult for farmers to repay their debts. The failure of the second Bank of the United States in 1838 disrupted the payment system because there was no central settlement and clearing system for the country as a whole. State governments experienced significant financial problems, because in many cases the States had issued bonds and created development banks to fund the failed canals and railroads.²⁶ By the 1840s, nine States had suspended payment on their debts. Some European creditors had greater doubts about the viability of Federal debt; others wanted the Federal Government to assume the State debts, as had been done with Revolutionary War-era debts.²⁷

The early 1840s had an interesting political environment.²⁸ The congressional majority often opposed President John Tyler, even though both were nominally of the same party. Tyler was not originally a Whig but had been added to the party ticket to broaden support for General William Henry Harrison. When President Harrison died shortly after inauguration, some members of Tyler's old party considered him a turncoat, while some in his new party referred to him as "His Accidency." At one point, his entire Cabinet except one resigned, and the House of Representatives began impeachment proceedings because of his use of the veto power.

CONGRESSIONAL DELIBERATION, ACTION, AND OVERSIGHT

The depression of the 1840s illustrates the effect of federalism on fiscal policy. Debt defaults and suspensions by State governments were of concern to European investors, many of whom also funded Federal debt or were members of countries with other outstanding issues with the United States.²⁹ Congressional documents indicate that some policymakers were concerned that State defaults could hurt the credit standing of the national government.

Although verbatim records of congressional debates were not kept at this time, there is evidence that the debate was vigorous. One faction of Congress favored Federal assistance to State governments and pointed out that Alexander Hamilton had orchestrated the assumption of State debts by the Federal Government. They also argued that paying the debts was good foreign policy. Another faction of Congress did not want solvent States to have to help pay the debts of States that had overbuilt during the canal and railroad boom.

Congress authorized a major study of the State debt issue. The study, headed by Congressman William Cost-Johnson, was an in-depth investigation into the causes and implications of economic distress in the States. The Johnson report recommended that Congress provide \$200 million in aid to the States, a large sum at the

²⁵ Peter Temin, *The Jacksonian Economy* (New York: Norton, 1969).

²⁶ John Joseph Wallis, *The Depression of 1839 to 1843: States, Debts, Banks*, University of Maryland, Working Paper, 2005.

²⁷ Jay Sexton, *Debtor Diplomacy: Finance and American Foreign Relations in the Civil War Era, 1837–1873* (Oxford: Clarendon, 2005).

²⁸ Frank Freidel and Hugh Sidey, *The Presidents of the United States of America*, White House Historical Association, 2006, summarized at <http://www.whitehouse.gov/about/presidents/johntyler>.

²⁹ William English, "Understanding the Cost of Sovereign Default: American State Debt in the 1840s," *American Economic Review* (March 1996), pp. 259–275.

time. Ultimately, Congress did not provide direct financial assistance to the States. With the Federal Government funded by tariffs, and State access to foreign credit markets impaired, fiscal policy was not used to address the depression of the 1840s.

Although Congress has the power of the purse, some were concerned that the President might use the treaty process to assist the States.³⁰ Many of the State debts were held by British creditors. Secretary of State Daniel Webster, the only Cabinet member not to resign, was negotiating with the British over a number of outstanding issues. British negotiator Ashburton was a financier with direct interest in State debts.³¹ The Senate passed a resolution to require the Secretary of State to provide assurance that State debts would not be included in negotiations with the British. The resulting Webster-Ashburton Treaty did not commit the Federal Government to assume or support State borrowing.

Other policy issues also came before Congress during the crisis. Congress considered but rejected the proposal to charter a third Bank of the United States. Although some regional payment systems evolved, banknotes from different parts of the country could exchange at a discount. Congress enacted a national bankruptcy law in 1841 to coordinate resolution of private debts and provide a fresh start for eligible borrowers. The bankruptcy law was repealed in 1843, making it effectively a temporary measure to address the crisis.³²

THE PANIC OF 1893 AND THE DEPRESSION OF THE 1890S

ECONOMIC AND INSTITUTIONAL CONTEXT

Although fiscal policy, banking regulation, and bankruptcy were issues in the 1890s, this section will focus on deliberations related to monetary policy. This case study illustrates Congress' continued discretion over monetary policy even when some might think commitment to the gold standard tied Congress' hands. Just as the case study for the 1840s showed that Congress considered changing fiscal policy but chose not to, the case study for the 1890s shows that Congress considered changing monetary policy but chose not to. Yet even though Congress did not change the monetary standard during the 1890s, the deliberations themselves may have had real effects.

Several of America's major trading partners entered recessions in the early 1890s, but the United States was not affected until after the panic of 1893, which initiated a period of economic slack that lasted until 1897.³³ Although exact unemployment statistics are not available, what can be said with some confidence is that unemployment was below 5 percent during 1890–1892, began rising in 1893, then remained above 10 percent between 1894 and 1898.³⁴

³⁰ Sexton, *Debtor Diplomacy*.

³¹ *Ibid.*

³² The Federal Judicial Center maintains a brief history of the bankruptcy courts at http://www.fjc.gov/history/home.nsf/page/courts_special_bank.html.

³³ The NBER identifies two different recessions during the depression of the 1890s. National Bureau of Economic Research, *U.S. Business Cycle Expansions and Contractions*, at <http://www.nber.org/cycles.html>.

³⁴ Christina Romer, "Spurious Volatility in Historical Unemployment Data," *Journal of Political Economy*, vol. 94, no. 1 (February 1986), pp. 1–37.

Perhaps because the early stages of the recession were international in scope, international capital flows did not provide relief.

At the time, the United States was part of the international gold standard. Because the dollar was defined in terms of gold and the pound and other currencies were defined in terms of gold, the result was a system of fixed exchange rates for participating countries. In addition to tying the dollar to a fixed ratio of gold (and excluding silver and other metals), the United States also committed to converting dollars to gold for certain international transactions. Because of the economic stress during the financial crisis and depression, Treasury borrowed four times during 1893–1897 in order to maintain the monetary gold reserves required under the international gold standard.³⁵

American participation in the gold standard (1873–1933) created rules for domestic and international monetary policy.³⁶ During the first part of the gold standard era (1873–1914), the notes of private banks circulated as money, and the private banks promised to convert the currency on demand. During the second part (1914–1933), the Federal Reserve took over the role of note issuer and assumed the associated obligations.

Joining the gold standard had required congressional action.³⁷ Various Mint Acts from 1792 onward defined the value of the dollar in terms of both gold and silver. At any moment in time, the proportion of circulating coins that were gold or silver depended on the relative price of the two metals. During times in which silver coins did not circulate, the de facto backing of the currency was effectively gold, even if the legal status of silver coins had not yet been altered. In 1873, during a time in which silver coins did not circulate, the Mint Act of that year did not provide for the coinage of silver. While this was a change in its legal status, it was not a change in its de facto status in 1873. Populists would later call the 1873 Mint Act the “Crime of ’73.”³⁸

Some might argue that participation in the gold standard tied policymakers’ hands. However, Congress had several avenues to change monetary policy. First, Congress could have amended the Mint Act to coin silver or other metals or to have fiat currency (unbacked). Second, Congress could have taken the extreme step of denying Treasury the ability to borrow to meet the commitments of the international gold standard. Third, Congress could have announced intentions to remain on the gold standard in the long run but suspended convertibility temporarily (as was sometimes done during wars). Fourth, Federal bank regulators in the Office of the Comptroller of the Currency (OCC) could have used their bank regulatory powers to affect bank-created money and employ their influence with the banks’ clearinghouses to affect the liquidity banks needed for interbank transactions.

³⁵ David Whitten, “Depression of 1893,” *EH Net Encyclopedia*, at <http://eh.net/encyclopedia/the-depression-of-1893/>.

³⁶ For a brief history of the rules of the gold standard, see Barry Eichengreen, “Globalizing Capital: A History of the International Monetary System,” *Journal of Comparative Economics*, vol. 26, no. 3 (September 1998), pp. 589–591.

³⁷ For a legal history, see Edwin Vieira, Jr., “The Forgotten Role of the Constitution in Monetary Law,” *Texas Review of Law and Politics*, vol. 77, no. 2 (1997–1998), pp. 77–128, at http://www.fame.org/PDF/viera_Texas_law.pdf.

³⁸ Friedman and Schwartz, *Monetary History*, pp. 113–116.

CONGRESSIONAL DELIBERATION, ACTION, AND OVERSIGHT

Opponents of the gold standard organized a national movement that resulted in the Populist Party. The Populist movement's challenge to "sound money" policies made the U.S. commitment to gold anything but certain at the time, perhaps best exemplified by Congressman William Jennings Bryan's famous "Cross of Gold" speech. Bryan and the Populists argued that tight monetary policy exacerbated the depression, in part because deflation increased the real burden of debts. In the Populists' view, indebted farmers were being "crucified on a cross of gold" as real interest rates rose and commodity prices fell.

Populists and sympathizers in the Republican and Democratic Parties called upon Congress to expand the money supply in order to combat deflation and the depression.³⁹ Congress could affect the supply of money even under the gold standard. For example, government silver purchases could expand the money supply by exchanging a safe financial asset that could be used as loan collateral (the silver certificate) for a commodity (silver) that could not.⁴⁰ Opponents of monetizing silver, including Presidents Grover Cleveland and William McKinley, argued that the United States should not leave the gold standard unilaterally because it would destabilize the dollar in international financial transactions, among other concerns.⁴¹ President Cleveland took it a step further and advocated repealing the Sherman Silver Purchase Act of 1890 to support the gold standard. In 1893, Congress concurred and repealed the act.

Whether good policy or bad policy, the debates surrounding the gold standard may themselves have been destabilizing. At the time, economist John B. Clark argued that uncertainty surrounding monetary discretion would contribute to debt binges and financial instability.⁴² Some critics have argued that the monetary uncertainty accompanying the political debates and the prospects of a Bryan victory in the Presidential election of 1896 contributed to the economic downturn of that year. They point to the second recession, which occurred only in the United States. The depression had been international until then.⁴³

Some modern economists are more sympathetic to Bryan's monetary positions. Economist Hugh Rockoff characterizes Bryan's ideas: "Bryan's monetary thought was surprisingly sophisticated and ... on most issues his positions, in the light of modern monetary theory, compare favorably with those of his 'sound money' opponents."⁴⁴

Congress considered changing the rules of the game. An example of congressional deliberations can be found in a December 16, 1897,

³⁹ Lawrence Goodwyn, *Democratic Promise: The Populist Movement in America* (New York: Oxford University Press, 1976).

⁴⁰ Richard C.K. Burdekin and Marc D. Weidenmier, "Non-Traditional Open Market Operations: Lessons from FDR's Silver Purchase Program," Claremont Institute for Economic Policy Studies, Working Paper Series 2005-08, 2005, at <http://www.claremontmckenna.edu/rdschool/papers/2005-08.pdf>.

⁴¹ Friedman and Schwartz, *Monetary History*, p. 118.

⁴² John B. Clark, "The After Effects of Free Coinage of Silver," *Political Science Quarterly*, vol. 11, no. 3 (September 1896), pp. 493-501.

⁴³ Whitten, "The Depression of 1893."

⁴⁴ Hugh Rockoff, "The Wizard of Oz as a Monetary Allegory," *Journal of Political Economy*, vol. 98, no. 4 (August 1990), pp. 739-760.

hearing before the House Committee on Banking and Currency.⁴⁵ The committee debated a bill to reform banking regulation and currency laws such that private banknotes would continue to circulate as currency but would have a guarantee from Treasury in the form of a national redemption fund. The bill would have also required Treasury to purchase silver as under the Silver Purchase Act of 1890. According to the congressional testimony of Treasury Secretary William Windom, the idea was to even more strongly commit to the gold standard but to do so in a way that did not reduce the national money supply.

Other congressional deliberations concerned more specific features of the financial system. For example, some Congressmen criticized Treasury borrowing to meet international obligations. The *Congressional Record* documents them complaining that the President was hiding profligate spending and attributing it to the requirement to maintain gold reserves. In modern terms, we might say they were pointing out that money is fungible.

In the end, the United States abided by the rules of the gold standard. However, doing so was by no means assured in the case of the monetary base, because returning to the pre-1873 Mint Act was a viable alternative. Furthermore, the need to borrow to meet international requirements of the gold standard required continued congressional consent during the crisis.

Although this section focused on monetary policy, the other three policy areas were also deliberated. Several State governments were again in danger of defaulting on their debts. Banking regulation was also an issue because obstacles to interstate banking had led to western mortgage debt being wrapped in securities called debentures and sold by trusts to eastern banks and investors. When western debt defaults rose during the 1890s, securities markets transmitted the distress to eastern banks and other financial institutions.⁴⁶ Congress responded to distressed businesses by passing another bankruptcy act. Unlike earlier temporary bankruptcy statutes in 1801 and 1841, this one was made permanent and is the foundation of the current bankruptcy code.

Following another panic in 1907, Congress created the National Monetary Commission to consider monetary reforms.⁴⁷ The result was the Federal Reserve Act of 1913, whose purpose was, in part, to foster monetary and banking stability by creating a more elastic currency. In deliberating the Federal Reserve Act, older Senators discussed the 1890s mortgage debentures problems, and the original Federal Reserve Act expressly included trusts in the definition of a bank and allowed trusts to be members of the system.⁴⁸

⁴⁵ U.S. Congress, House Committee on Banking and Currency, *Hearings and Arguments on Proposed Changes in the Currency System of the United States*, 55th Cong., 1897–1898 (Washington, DC: GPO, 1898).

⁴⁶ Andrew M. Davis, U.S. Congress, Senate National Monetary Commission, *The National Banking System*, 61st Cong., 2d sess., 582 (Washington: GPO, 1910–1911); and Kenneth A. Snowden, *The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s*, National Bureau of Economic Research, July 2010, <http://www.nber.org/papers/w16244.pdf>.

⁴⁷ O.M.W. Sprague, U.S. Congress, Senate National Monetary Commission, *History of Crises under the National Banking System*, 61st Cong., 2d sess., Document 538 (Washington: GPO, 1910).

⁴⁸ U.S. Congress, Senate Committee on Banking and Currency, *Hearings*, H.R. 7837 (S. 2639), 63d Cong., 1st sess., September 2, 1913, Document 232 (Washington: GPO, 1913).

THE GREAT DEPRESSION

ECONOMIC AND INSTITUTIONAL CONTEXT

The Great Depression was an extended period (1929–1941) of high unemployment and a variety of fluctuations including financial shocks and a short, modest recovery. There had been a boom period in the 1920s. The stock market crashed in 1929, borrowers defaulted, banks failed, and industrial firms laid off workers. Commodity prices collapsed, farm values declined, and many farms went into foreclosure. Nonbank financial institutions failed because they could not raise sufficient funds by liquidating the securities they held as collateral because of declines in financial markets. More than 12,000 banks failed.

In September and October 1929, the New York Stock Exchange started a decline that continued until July 1932, when it had fallen 89 percent from its high. It did not recover to the September 1929 level until November 1954. Although the 1929 stock market crash may have signaled the beginning of the Depression in the United States, economic contraction was actually a worldwide event that had begun earlier in other locations.

In 1933, the trough of the Great Depression, real gross domestic product (GDP)—production of final goods and services adjusted for inflation—was down 26.7 percent of its previous peak in 1929. By way of comparison, the trough in the recent recession was in 2009, when real GDP had declined by 3.1 percent from its peak. In the Great Depression, unemployment peaked at 24.9 percent in 1933.⁴⁹

Prices as measured by the Consumer Price Index declined. Most economists consider deflation to be a greater problem than price level increases of a similar scale, because it can set in motion a vicious cycle of economic decline. Falling prices encourage consumers and businesses to postpone purchases because things will be cheaper to buy in the future. When prices are broadly declining, nominal wages and nominal business revenues tend to fall. This discourages consumer borrowing because it will be more difficult to pay back the loan out of lower incomes. Businesses are also discouraged from borrowing, because when their revenues decline, there is less need to borrow and repaying the loans will be more difficult. In 1929, there was no change in prices, but in 1931 the price level fell by 7 percent. Between 1929 and 1932, prices fell 16 percent. Until early 1933, prices continued to fall but then began a general (but not uniform) increase.

CONGRESSIONAL DELIBERATION, ACTION, AND OVERSIGHT

At the outset of the Great Depression, the country already had a financial regulatory framework designed for crisis response. The OCC had been created following the panic of 1857 with banking and currency related powers, and the Federal Reserve had been created following the panic of 1907 with monetary policy powers. The bankruptcy law enacted during the depression of the 1890s was still in effect. The case studies in this section illustrate contin-

⁴⁹ For an indepth analysis of unemployment in the Great Depression and the Great Recession, see CRS Report R40655, *The Labor Market During the Great Depression and the Current Recession*, by Linda Levine.

ued congressional discretion and examples of Congress choosing to change the rules (often temporarily), even if the rules of the game already encompass a response mechanism. Congress retained discretion and did take action to change the authorities and programs in place before the crisis.

Many comparisons have been made between the recent Great Recession and the Great Depression of the 1930s. Although there may be a common belief that Congress during the Hoover administration did nothing, historians are well aware that Congress took numerous steps during the deepest parts of the Depression (1930–1933). Because several policymakers during the 2007–2009 crisis consciously referenced lessons from the Great Depression in their own policy responses, this section and the section for the 2000s will treat each of the four policy areas separately. A comprehensive list of all congressional policies during the two periods would take many pages, so these sections merely provide illustrative examples.

Fiscal policy

With the end of World War I in 1918, the government's military expenditures declined, and the Federal Government began to run a budget surplus. Until the stock market crash of October 1929, the 1920s—sometimes called the “Roaring Twenties”⁵⁰—were a time of general economic growth and prosperity in the United States and internationally. To balance the budget, Congress had cut taxes with the Revenue Act of 1921,⁵¹ the Revenue Act of 1924,⁵² the Revenue Act of 1926,⁵³ and the Revenue Act of 1928.⁵⁴ Treasury Secretary Andrew Mellon proposed further cuts in 1929, but Congress rejected them.⁵⁵ Some Members of Congress objected to these tax cuts. For example, Senator Robert La Follette argued against the tax cuts on the grounds that they favored corporations and high-income individuals because income taxes were levied only on high-income households at that time.⁵⁶

Once the Great Depression began, the Federal Government's budgets were in deficit under both Hoover and Franklin D. Roosevelt. These deficits were primarily due to declining tax receipts as part of the automatic stabilizers. Federal spending, adjusted for deflation, increased. The budget deficits were too small relative to the economy for many modern economists to believe that they would have any meaningful expansionary effect.

As the Great Depression deepened, the Hoover administration called on Congress to increase taxes. For example, in 1932, Secretary Mellon testified that there would be a \$200 million budget

⁵⁰ The phrase “Roaring Twenties” is something of a misnomer, because there were three recessions in the decade before the official start of the Great Depression in August 1929.

⁵¹ 42 Stat. 227; *New York Times*, “Conferees Finish Work on Tax Bill,” November 20, 1921, p. 14; and *New York Times*, “Democrats Assail Tax Bill Changes,” October 6, 1921, p. 4.

⁵² 43 Stat. 253; *New York Times*, “Tax Conferee Fight Fizzles in Senate: Democrats Abandon Fight for Majority of the Five Who Meet House Group Today,” May 14, 1924, p. 21.

⁵³ 44 Stat. 9; W.M. Kiplinger, “Prosperous America Cuts Taxes Again: New Law Relieves 2,000,000 People of Levy on Their Incomes,” *New York Times*, February 28, 1926, p. 25.

⁵⁴ 45 Stat. 791; *New York Times*, “Congress Voted \$4,628,045,035: Largest Peace-Time Budget Exceeds Its Predecessor by \$478,542,508,” June 7, 1928, p. 4.

⁵⁵ *New York Times*, “Hoover and Mellon Agreed on Tax Cut: White House Denies Reports of a Conflict on Possible Reductions,” July 4, 1929, p. 3.

⁵⁶ *New York Times*, “La Follette Scores Relief Compromise,” February 11, 1931, p. 2.

deficit and that taxes should be increased to balance the budget.⁵⁷ Congress debated the dangers of running a deficit and passed the Revenue Act of 1932 (P.L. 72–154), which increased income taxes on high-income households, the only ones paying income taxes in those days. Even after these tax increases, tax revenues continued to fall.

However, to say that the Federal Government's budget was too small relative to the economy to have a meaningful effect is not the same as saying the government did not pursue any legislation that was technically expansionary (even if too small to matter in the aggregate). Although the real value (adjusted for inflation) of overall economic spending declined by nearly a third between 1929 and 1932, real Federal Government expenditures actually increased. However, this increase in Federal spending was partially offset by a decline in State and local government spending.⁵⁸

A number of employment programs were passed and signed into law or created by Executive order. Within the Roosevelt administration, there were debates over the goals of the programs.⁵⁹ Some argued that their primary emphasis should be on employing those out of work, while others argued that the primary emphasis should be on building infrastructure at the least cost. In addition, Federal, State, and local governments provided direct relief to the unemployed. Legislation to create new infrastructure was controversial.⁶⁰ President Hoover vetoed the Emergency Relief and Construction Act of 1932 as originally sent to him but signed an amended version (P.L. 72–302). Other related bills never made it out of Congress.

Monetary policy

Through the Federal Reserve Act, Congress had delegated much of monetary policy to the independent agency. During the 1920s, the Federal Reserve had an active, countercyclical monetary policy that was credited with alleviating a recession in 1921, slowing overly rapid growth in early 1923, and prompting an expansion after the 1923–1924 recessions.⁶¹ These seeming policy successes and the relatively brisk economic growth during the 1920s caused some to believe that the Fed could stabilize the economy.⁶² In order to support Great Britain's attempt to resume convertibility to gold, the Federal Reserve eased monetary policy in the late 1920s. Some think that this may have contributed to an acceleration of asset prices in the United States.⁶³ The Federal Reserve appears to have grown more confident during the 1920s that monetary policy could be used to stabilize the economy. When the stock market boom ac-

⁵⁷ Roy G. Blakey and Gladys G. Blakey, *The Federal Income Tax* (New York: Longmas, Green and Company, 1940).

⁵⁸ Federal Reserve Bank of St. Louis, *Federal Reserve Economic Data*, at <http://research.stlouisfed.org/fred2/series/FYFSD#>. Converted to calendar years by CRS.

⁵⁹ See, for example, Lester V. Chandler, *America's Greatest Depression 1929–1941* (New York: Harper and Row, 1970), pp. 193–194.

⁶⁰ Chandler, "Chapter 11."

⁶¹ Friedman and Schwartz, *Monetary History*, p. 296.

⁶² Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (Oxford: Oxford University Press, 1992).

⁶³ Alan H. Meltzer, *A History of the Federal Reserve, Volume 1: 1913–1951*, (Chicago: University of Chicago Press, 2004), p. 139.

celerated in the late 1920s, the Federal Reserve took actions to deflate the bubble.⁶⁴

While the administration of monetary policy had been delegated to the Federal Reserve, Congress still determined the definition of the dollar in terms of gold. In addition, Congress retained the power to alter the authority of the Federal Reserve and the OCC. Congress retained the power to provide financial support to banks and facilitate the resolution of failed banks.

The collapse in growth of the money supply was caused by three distinct banking panics in 1930, 1931, and 1933. Bank suspensions and failures shrank the money supply directly by reducing checkable deposits. The Federal Reserve did not intervene aggressively to mitigate bank failures. Bank failures created practical obstacles for the extension of credit, such as the loss of borrower records, which reduced the potential effectiveness of monetary policies. This can be seen in the 33 percent drop in the money supply in the United States, compared to a 13 percent drop in Canada during 1929–1933, which did not suffer similar waves of bank failures.⁶⁵ Some economists believe that the Federal Reserve's decision to allow the money supply to drop contributed to the severity of the Depression in the United States, although the drop in economic activity was similar in both countries.⁶⁶

As in the depression of the 1890s, the economic “rules of the game” purportedly limited the range of available policy actions. As in the 1890s, Congress retained the power to alter those rules. First, Congress could leave or suspend the gold standard and pursue expansionary monetary policies. Other countries did this. Second, Congress could alter the powers and authorities of the Federal Reserve and the OCC. Third, Congress could authorize direct assistance to banks or pass legislation facilitating orderly liquidation of banks.

Many modern economists consider Federal Reserve inaction even within the constraints of the gold standard to be a factor in the duration and intensity of the Depression. Although the Federal Reserve took a number of steps to lower interest rates and make occasional open market purchases, the Fed quickly ceased because of fears of inflation or an international run on the dollar. To many modern observers, these fears seem like strange concerns, especially given the deflation of the time, although there was eventually a run on the dollar after the election results of 1932.

The congressional role was largely one of oversight at the beginning of the Depression. Officials from the Fed and the OCC testified before Congress along with submission of their regular agency reports. Hearing transcripts reveal a variety of congressional concerns. For example, the international status of the dollar was regularly discussed. Other issues included the rules for membership of banks in the Federal Reserve System, the types of bank assets that

⁶⁴James D. Hamilton, “Monetary Factors in the Great Depression” *Journal of Monetary Economics*, vol. 19, no. 2 (March 1987), pp. 145–169.

⁶⁵Friedman and Schwartz, *Monetary History*, p. 352.

⁶⁶The quantity theory of money states that $MV = PY$, or that the money supply times the velocity of money equals the price level times the economy's production (usually measured as real net national product, or NNP). The contraction of the real NNP was comparable in the United States and Canada (–53 percent vs. –49 percent) because the bulk of the difference in $MV = PY$ was borne by velocity (V , –29 percent vs. –41 percent), instead of Y (NNP).

could be used as collateral for loans from the Fed, and several structural issues that will be discussed in the banking section.

As the Depression deepened and dragged on, there was legislation related to temporarily increasing the money supply. Senators William Borah and Carter Glass wanted to increase the supply of circulating safe assets that could be used as collateral for private loans. Recall that in addition to coin-backed notes, transactions can be funded by loans against relatively safe collateral. In June 1932, the Senate Banking and Currency Committee reported out the Glass bill, which was designed to make Government bonds eligible to increase money in circulation in this manner. Although President Hoover opposed the approach as unnecessarily tying circulating medium to the existing supply of assets (unlike the Federal Reserve, which could adjust the money supply more elastically), the concept was enacted as part of the Federal Home Loan Bank bill (discussed more below) as the Glass-Borah rider.⁶⁷

After the passage of the Glass-Borah rider, Congress broadened the authority of the Federal Reserve to expand the money supply. Glass had been a major figure in the 1914 creation of the Federal Reserve. At the time of the establishment of the Federal Reserve, Glass had believed that a central bank should loan to banks only on good collateral, which was defined at the time as self-liquidating collateralized commercial credit and other real bills, not Government bonds.⁶⁸ Under this real bills doctrine in 1914, the Federal Reserve could not use government debt for important monetary purposes, as it was thought that open market operations fueled “speculation,” not productive investment. By 1932, Glass and many others had changed their minds about the real bills doctrine, and Congress passed and Hoover signed legislation expanding the range of collateral eligible for Fed discounting and broadened the range of eligible collateral to include government debt.

As in the 1890s, uncertainty about political outcomes could affect the credibility of the monetary standard. For example, at the time there was a 5-month gap between November elections and the inauguration of the President in March of the next year. Uncertainty about whether Roosevelt would remain on the gold standard caused international central banks to liquidate U.S. securities that they held in lieu of monetary gold. This was effectively a run on the dollar, and previous attempts to defend the dollar against such a run had contributed to monetary contraction. Domestically, bank depositors withdrew their funds, and several State banking systems collapsed. President Hoover asked President-elect Roosevelt to make an announcement that he would honor gold, but Roosevelt refused. In hindsight, the international central banks and domestic depositors who dumped dollars were correct in that President Roosevelt did devalue the dollar upon taking office.

Congress included legislation that devalued the dollar in terms of gold in the emergency actions that accompanied FDR’s first hundred days. As discussed in the general description of monetary policy, economists have noted that several countries experienced recoveries after abandoning the gold standard. Recovery for the

⁶⁷ American Institute of Banking, “Anti-Depression Legislation: A Study of Acts, Corporations, and Trends Growing Out of the ‘Battle with Depression,’” December 1933, p. 73.

⁶⁸ Meltzer, *History of the Federal Reserve*, pp. 138–139.

United States also began after devaluation. In devaluing the dollar, the 1933 acts also abrogated gold-based cost-of-living adjustments in private debt contracts and in Treasury bonds. The gold index clause provision is relevant because otherwise the monetary revaluation would have been offset by matching debt-burden adjustments in contracts that had the clauses. The value of railroad bonds, U.S. Liberty bonds, and many other securities remained in doubt until the Supreme Court ruled against restitution for bondholders in 1935.

*Banking regulation and assistance*⁶⁹

Bank failures can exacerbate a recession in a number of ways. First, because deposits serve as money, and banks loan a fraction of their deposits, bank failures can shrink the money supply. Second, bank failures can impair the channels by which people desiring credit can access funds so that lower interest rates do not translate into more people taking out loans.⁷⁰

Congress did not act immediately to address bank failures or the monetary contraction that those failures contributed to. However, as the Depression deepened, Congress took a number of actions to directly assist banks and other financial institutions while Hoover was President. In many cases, a coalition of progressive Republicans and Democrats helped to pass the legislation. During the Hoover administration, the chairman of Senate Banking and Currency, Republican Senator Peter Norbeck, had been active in creating direct government lending institutions and other financial assistance programs at the State level. He was part of the mid-western farm progressive wing of the party and did not have ideological opposition to government intervention per se, although he thought State governments should take the lead in some areas. Senator Norbeck hired Ferdinand Pecora to begin analyzing the role of banking in the Depression, resulting in the Pecora Commission.

Congress held hearings to try to diagnose the problems in banking. Congress may have had difficulty linking the bank failures of the early 1930s to problems with the macroeconomy because there had been many bank failures during the boom of the 1920s. For example, the head of the OCC testified to Congress in 1931 that the bank failures were due to the structure of the U.S. banking system rather than to monetary conditions. At the time, the United States still had thousands of small, undiversified regional banks, because most States prohibited branch banking. In the 1920s, before the Depression started, hundreds of banks failed each year. The head of the OCC testified before Congress that one solution to the banking problem would be to preempt State law and to allow branch banking. That is, he argued that the banks that were failing were inefficient and should be failing.

By 1932, both Congress and the President were willing to take direct action to assist the banking system. One major change was Glass-Steagall I, which responded to “toxic” assets held in the

⁶⁹ A detailed contemporary history of banking-related legislation was compiled by the American Institute of Banking in *Anti-Depression Legislation*.

⁷⁰ Ben S. Bernanke, “Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression,” *American Economic Review*, vol. 73, no. 3 (June 1983), pp. 257–276.

banking system. Problems in securities markets had made some of the securities held by banks unmarketable. The crisis in securities-based lending was alleviated by expanding the range of collateral eligible for the Federal Reserve.

Another measure that provided direct assistance to banks was the establishment of the Reconstruction Finance Corporation (RFC).⁷¹ Congress passed and Hoover signed legislation creating an agency with authority to provide direct financial assistance to struggling banks and other financial firms. At first, the RFC loaned money to banks. When Roosevelt took office, RFC assistance to banks was transformed more often to capital injections. The RFC eventually became a creditor to many kinds of financial institutions and entities, not just banks—including the State of Arkansas, whose entire debt was purchased for 1 year by the RFC.

Congress also passed and Hoover signed another piece of legislation to give smaller financial institutions greater access to credit markets. The Federal Home Loan Bank (FHLB) system was designed to allow banks and mortgage lenders to form what were essentially mutual associations to borrow through securities markets as a single entity. These FHLBs are government-sponsored banks that lend to bankers, not to individual household or business borrowers. Initial funding for the FHLB system came from the newly created RFC.

Upon the election of Roosevelt and a new Congress, the United States took immediate new steps to address problems in the banking system. First, because the third wave of bank failures and the run on the dollar had occurred immediately prior to his inauguration, Roosevelt took a number of steps. He declared a banking holiday. The financial condition of all banks was reviewed, and only healthy banks were allowed to reopen. Roosevelt directed the RFC to switch from loans to capital injections, and he devalued the dollar in terms of gold internationally, which increased the real value of monetary reserves and stimulated net exports.⁷²

Congress passed the Banking Act of 1935 (P.L. 73–66), which expanded the Federal Reserve's powers. It moved power from the regional banks to the Board of Governors and its chairman. The act also made the Fed independent of Treasury.

Bankruptcy and debt restructuring

As in the 1890s, rapid deflation increased the real burden of debts as wages and prices fell while the nominal value of debts were unchanged. There were widespread business failures, farm foreclosures, municipal defaults, and personal insolvencies. Farm mortgages were particularly problematic to resolve. On the one hand, the decline in property values reduced the ability of lenders to recover the value of the loan through foreclosure so they might have been willing to work things out. On the other hand, problems in financial institutions' access to credit described above made it

⁷¹ A history of the RFC was written by its early official, Jesse Jones. Jones notes that during his 13-year tenure, each successive Congress broadened the powers of the RFC. See Jesse H. Jones, *Fifty Billion Dollars: My Years with the RFC, 1936–1945* (New York: Macmillan, 1951).

⁷² The trade effect was likely minimal, because many countries enacted protective trade laws in response to the United States raising tariffs.

imperative to recover funds as quickly as possible. Similar tradeoffs existed for nonbank lenders as well.

As farm foreclosures increased, several State governments began responding to farmers' concerns. Several States enacted a mortgage foreclosure moratorium, preventing lenders from seizing property. In some places private citizens reportedly tried to intimidate potential bidders at foreclosure sales so people could buy their properties back.

Congressional action to address foreclosures was included in the Federal Home Loan Bank Act. The act included a temporary delay of foreclosure proceedings for certain banks. The newly created RFC could advance the funds to cover delayed payments to institutions that were joining the system.

Debt restructuring was also affected by the method used to go off the gold standard. The gold acts did not just permit flexible exchange rates; they also invalidated gold index clauses. A gold index clause was similar to a cost-of-living adjustment. If the gold index clauses had not been invalidated, then when Congress revalued gold from 16:1 to 35:1, the balance for debts with gold clauses would have risen by 60 percent. Congress invalidated not only gold clauses in its own bonds but also such clauses in private contracts.

Congress responded to the Great Depression with many other programs for specific economic sectors. Examples include the Agricultural Adjustment Act and the National Industrial Recovery Act, but this report is limited to the policy areas described in the introduction.

2000S AND THE GREAT RECESSION

ECONOMIC AND INSTITUTIONAL CONTEXT

Like the Great Depression, the country already had a financial regulatory framework designed for crisis response at the outset of the Great Recession. In addition to the OCC and the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC) was in place to prevent bank runs, and other agencies and legal frameworks were in place designed to facilitate confidence in financial markets and their continued functioning. Like the Great Depression section, the case studies in this section illustrate continued congressional discretion and examples of Congress choosing to change the rules of the game (often temporarily), even if the rules already encompass a response mechanism. Many congressional and agency actions taken to combat the Great Recession, including temporary measures, were analogous to similar actions during the Great Depression.

Even though the legal framework differed in significant ways, some of the economic issues of the Great Recession of 2007–2009 resemble those of prior depressions. A period of debt-funded expansion was followed by a financial crisis and a period of extended unemployment.⁷³ Once the recession began, investment lagged despite low interest rates. As in the 1840s, State financial problems were a drag on fiscal policy. As in the 1890s, defaults on mortgages

⁷³National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report*, January 2011, <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

wrapped in securities transmitted losses through the capital markets. As in the 1930s, when market transactions in the securities halted, it became difficult for financial institutions that held the securities to value them or to use them as collateral for loans. Like in the 1930s, there was a crash in the repurchase agreement market.⁷⁴

By most measures, the Great Recession was milder than the Great Depression. Some of that difference may be due to differences in policy, but some of the difference may have been due to differences in the nature of the economic shocks that started the crises. Unemployment during the Great Recession peaked at less than half the peak of the Great Depression. Unlike the deflation of the Great Depression, the price level remained relatively stable during the Great Recession.

During the 2000s, more of congressional emergency authority had been delegated to independent agencies than in prior crises. The Federal Reserve was given broad emergency lending powers in section 13(3) of the Federal Reserve Act. Leaving the gold standard and eventually adopting floating exchange rates freed the Federal Reserve from some external constraints on monetary policy decisions.⁷⁵ The FDIC existed to dissuade depositors from running on banks, and the FDIC had the authority to temporarily increase its coverage. The Securities and Exchange Commission could limit trading on certain stock transactions. These delegations meant that some rules could be changed even if Congress took no action, although Congress still conducts oversight. Policymakers in the agencies had more options available to them in the 2000s without having to ask for additional congressional authority or to negotiate internationally.

Furthermore, key policymakers such as Federal Reserve chairman Ben Bernanke and Council of Economic Advisers chair Christina Romer had spent part of their academic careers studying the causes of the Great Depression. Bernanke and Romer both felt that tight monetary policy and Federal Reserve inaction had contributed to the Depression.⁷⁶ Furthermore, they both believed that sustained recovery did not occur until the gold standard had been abandoned, increasing money flows in the United States.

CONGRESSIONAL DELIBERATION, ACTION, AND OVERSIGHT

Fiscal policy

Federal fiscal policy was deliberately expansionary during the early stages of the mortgage crisis and the subsequent recession.⁷⁷ The Federal Government's deficit increased during both the Great Depression and the Great Recession, although nearly twice as

⁷⁴ Ibid.

⁷⁵ Domestic convertibility of gold was suspended in 1933. International convertibility was suspended in 1972.

⁷⁶ Ben S. Bernanke, "Remarks on Milton Friedman's Ninetieth Birthday," November 8, 2002, at <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/>.

⁷⁷ The formal macroeconomic theories of expansionary fiscal policy were not widely accepted until after the publication of John Maynard Keynes' *General Theory* in 1935. Although there were people who advocated deficit spending in recessions prior to 1935, they did not do so on Keynesian grounds. In contrast, policy discussions and congressional deliberations in the 2000s expressly considered the Keynesian framework for macroeconomic policy decisions.

much during the Great Recession in relation to GDP.⁷⁸ This expansionary set of policies at the Federal level was partially offset by tight conditions at the State level. As the economic malaise endured, Federal fiscal policies became less expansionary. This section of the report will focus on fiscal policies in three periods: (1) after mortgage turmoil began but before the financial panic in September 2008, (2) from the 2008 panic until the 2010 elections, and (3) after 2010.

Even before the beginning of a recession had been officially declared, policymakers took steps for expansionary fiscal policy. Turmoil in financial markets erupted during the summer of 2007, and policymakers began considering responses shortly thereafter. General economic conditions were flattening out, and a recession began in December. However, the formal dating of recessions is backward-looking, so in early 2008 no one knew that a recession had started. In order to reduce the risk of a recession, Congress enacted a tax cut in early 2008 designed to maintain consumer spending. Despite this action, economic conditions continued to worsen, perhaps because this tax cut was relatively small as a share of GDP.

Declines in State and local spending partially offset Federal fiscal actions throughout the period. Many States have balanced budget requirements in their State constitutions. State legislators are therefore unable to change their budget rules of the game merely through legislation. Many local governments rely on property taxes as a significant source of revenue, and these sources of funds were particularly hard hit when the housing bubble popped. As a result, many State and local governments were cutting spending and raising taxes when the Federal Government was increasing the size of its deficits. Furthermore, investor confidence in the creditworthiness of several State governments began to deteriorate, as measured by the spread between their borrowing costs and Federal borrowing costs and by the ratings agencies. California even temporarily issued its own monetary scrip in response to its budgetary woes.

After the financial panic in September 2008 and the election of a new President with majorities in both Chambers of Congress of his own party, Federal fiscal policy became even more expansionary. In part, this was due to automatic stabilizers that act countercyclically and thus tend to increase Federal spending and reduce Federal tax receipts during a recession. However, it was also due in part to legislation designed to be expansionary.

There were several fiscal policies designed to temporarily suspend rules. There was a temporary suspension of the collection of a portion of payroll taxes (P.L. 111–312). During the Great Recession, the American Recovery and Reinvestment Act (P.L. 111–5)⁷⁹ was characterized as the primary stimulus bill. In addition to public works funding, it included tax cuts, provided money for expanded unemployment assistance, and granted financial support to State and local governments. There was also a temporary program

⁷⁸ Bureau of Economic Analysis, U.S. Department of Commerce, *Net Federal Government Saving*, downloaded from St. Louis Federal Reserve Bank, <http://research.stlouisfed.org/fred2/series/AFDEF>. This is in current dollars.

⁷⁹ For more information, see CRS Report R40537, *American Recovery and Reinvestment Act of 2009 (P.L. 111–5): Summary and Legislative History*, by Clinton T. Brass et al.

for a special class of bonds to facilitate infrastructure spending (Build America bonds). Other programs, such as “cash for clunkers” and a first-time homebuyer tax credit, were targeted at specific economic sectors.

After the 2010 elections, which resulted in a Republican majority in the House and reintroduced divided government, fiscal policies became less expansionary.⁸⁰ Concerned that continued Federal budget deficits would be a long-term problem, the Republican House negotiated for spending cuts during debt ceiling talks, resulting in legislation that capped discretionary spending. With Congress unable to reach a consensus during the appropriations process, a series of continuing budget resolutions effectively froze Federal spending for a time. Disagreements between the Republican House and the Democratic Senate and President resulted in a shutdown of the Federal Government.

Monetary policy

The Federal Reserve under Bernanke deliberately rejected several policies of the 1930s in favor of more expansive programs.⁸¹ The Fed uses different tools in its various roles. To implement monetary policy, the Federal Reserve buys and sells Government bonds (i.e., conducts open market operations). As lender of last resort (LOLR), the Federal Reserve can provide emergency lending to distressed banks. To counter illiquidity in the financial system, the Federal Reserve can expand the types of collateral that it will lend against. The Federal Reserve used its existing authorities to take more aggressive action than it had taken in the 1930s.

The Federal Reserve used its LOLR powers to facilitate the rescue or sale of some distressed financial institutions. Under normal conditions, the LOLR authority is limited to commercial banks that are members of the Federal Reserve System. During the mortgage crisis, the Fed extended access to its LOLR facilities to nonmembers. In March 2008, the Fed provided a loan to assist JPMorgan in acquiring failing broker-dealer Bear Stearns. The Fed and JPMorgan loaned to a newly created entity called Maiden Lane, which held a pool of Bear Stearns assets for which JPMorgan took first loss and the Federal Reserve received senior treatment. The Federal Reserve considered using the Maiden Lane structure to intervene on behalf of the broker-dealer Lehman Brothers in September 2008, but this did not happen. A financial panic occurred when the Lehman’s bankruptcy was announced. The Federal Reserve used the Maiden Lane structure to intervene on behalf of the insurer AIG.

The Federal Reserve used its authority to lend against good collateral to set up a number of temporary liquidity programs designed to address illiquid assets. As discussed above, the ability of securities to act as good collateral in private transactions erodes

⁸⁰ Because some government spending and tax receipts respond to economic conditions, there is an automatic stabilizer effect for fiscal policy. Fiscal policy becomes expansionary during recessions because deficits naturally grow and contractionary during booms as tax receipts generally rise. Economists therefore use a measure, called the full employment budget, to account for this natural fluctuation in the budget over the business cycle. As measured against the full employment budget, Federal fiscal policies after 2010 were contractionary.

⁸¹ Ben S. Bernanke, “Speech on Monetary Policy Since the Onset of the Crisis,” August 31, 2012, at <http://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm>.

during a panic, including for nonbanks. If so, not only may aggregate credit decline, but specific lines of businesses that had relied on collateralized lending structures may be unable to roll over their debt to continue to finance existing operations. When trading in several classes of asset-backed securities (ABS) collapsed during the crisis, they could no longer be valued to be used as collateral for further loans. Although banks could use ABS as collateral, the Term Asset Loan Facility (TALF) enabled nonbanks that held ABS that had become toxic during the crisis to obtain short-term loans from the Fed. Like the expansion of LOLR powers, access to TALF was not limited to member banks of the Federal Reserve System.

Since the start of the 2007–2008 recession, the Federal Reserve has used open market operations to lower interest rates and stimulate lending. With short-term interest rates almost zero, the Federal Reserve has taken a number of unprecedented additional steps to stimulate the economy. It has characterized these actions, including quantitative easing (QE), as both extraordinary and temporary. Under QE, the Federal Reserve purchased securities to expand its balance sheet (and the money supply) by purchasing longer term Treasury debt and mortgage-related bonds and securities. The Federal Reserve also made swap arrangements with foreign central banks to make sure that dollars, which are the worldwide reserve currency, were available to the international finance system.

In its oversight role, Congress called Fed officials to testify before committees to diagnose the economic problem and explain Federal Reserve actions (or inactions) to address the crisis. At times, some Members of Congress were dissatisfied with the level of information provided, and Congress ultimately passed legislation that provided greater oversight powers of certain Fed programs, including expanding Government Accountability Office audit power for some Fed functions. Dissatisfied with the ad hoc nature of the response to the financial crisis and convinced by Fed officials that lack of authority prevented further action, some Members of Congress called for expanding the Federal Reserve's powers and mission. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111–203) granted the Fed greater regulatory authority over some nonbank financial institutions, transferred some of the Fed's mortgage-related and consumer protection regulatory powers to a new agency, and eliminated the ability of the Fed to use a Maiden Lane-type structure for individual institutions. Proposals to alter the Fed's monetary policy mission, such as inflation targeting, were discussed but not enacted. Some Members of Congress expressed doubts about the effectiveness and longrun implications of QE and growing Federal debt.

Banking regulation and financial institution intervention

As discussed above, the Federal Reserve used the Maiden Lane structure on an ad hoc basis to rescue some financial institutions. In some cases, these firms were performing money-creation services similar to banks, but they were not chartered commercial banks and did not have direct access to some Federal Reserve facilities. In one example, broker-dealers used repurchase agreements to fund credit for other financial transactions. Refusal to roll over re-

purchase agreements has been likened to a run by bank depositors. Monetary conditions, if defined broadly enough to include credit generated through repurchase agreements, were more stringent than traditional measures might indicate. Also, two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac—which served as intermediaries between mortgage markets and securities markets—became distressed.

Congressional response took many forms, but in the interest of space, this report will focus on just a few. First, Congress enacted the Housing and Economic Recovery Act of 2008 (HERA; P.L. 110–289). This act gave the Secretary of the Treasury authority to give direct financial assistance to the GSEs. Using this authority, Treasury and the newly created Federal Housing Finance Agency placed the GSEs in conservatorship. The panic of September 15, 2008, began less than 2 weeks after Treasury exercised its HERA powers.

Congress also passed the Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110–343). EESA was the primary tool for providing financial assistance to the banking system and related institutions. It was also used to assist automakers and some homeowners. EESA gave the Secretary of the Treasury temporary authority to acquire mortgage-related assets or any other asset that the Secretary believed could assist financial stability. Initially, EESA was used to inject capital into financial institutions by purchasing their preferred shares—the Capital Purchase Program—and became colloquially known as the bank bailout, although the return was positive for the government. The EESA Capital Purchase Program included a wide variety of financial firms, from firms that formerly had been the broker-dealers in the repurchase agreement market to some very small community banks. It is worth noting that the first vote on EESA failed, and financial markets fell further upon the news.

EESA also contained a provision related to money market mutual funds (MMFs). During the panic, one MMF “broke the buck,” meaning that investors lost principal in this usually safe liquid investment product. Investors then began withdrawing funds from MMFs more generally. Treasury exercised authority left over from the gold standard to announce a temporary guarantee program for MMFs. EESA included a provision to prevent further use of the Exchange Stabilization Fund as a guarantor of MMFs.

Bankruptcy and debt restructuring

Congress confronted many issues related to the treatment of distressed debt, as might be expected in a crisis driven by mortgage defaults. Congress deliberated at least three areas of concern. First, as discussed in the Fed’s LOLR role, policymakers were concerned about the resolution of nonbanks through the bankruptcy system. Second, the relatively large number of banks failing presented Congress with concerns over the financial soundness of the FDIC. Third, individual homeowners who were in default sought relief from lenders. Although mortgage foreclosure moratoriums were never enacted, delays of the foreclosure process were achieved through other means.

Initially, policymakers created voluntary programs to encourage mortgage modification rather than foreclosure. For example, when house prices first began falling, the administration created the Hope Now Program to encourage voluntary modifications by mortgage servicers that acted on behalf of the owners of mortgage-backed securities. Dissatisfied with the results, Congress passed legislation to insulate mortgage servicers from potential investor lawsuits if they offered modifications before a homeowner missed payments.

As bank failures increased, the FDIC inherited a portfolio of distressed mortgages owned by failed banks. In its role as receiver, the FDIC initiated a program of mortgage modifications for the loans it controlled. Called the IndyMac Program for one of the failed depository institutions, the FDIC program became a model for other Federal initiatives.

Mortgage servicers were compelled to delay foreclosures in some cases and encouraged to in others. For example, Congress passed legislation requiring banks that participated in EESA to offer mortgage modifications. Similarly, the conservatorship of the GSEs was used as a vehicle for mortgage modification programs such as Home Affordable Refinance Program and Home Affordable Modification Program. In addition, mortgage modification policies were achieved by a negotiated settlement to end some lawsuits against the banks that had the largest share of the mortgage servicer business.

Conclusion

Just as a glass may be described as half full or half empty, history may reveal continuity or change. The episodes described above contain some continuities. During financial crises, people have asked for temporary changes to the existing rules of the game. Furthermore, even though the institutional frameworks of 1840, 1893, 1930, and 2008 were vastly different, there are consistencies in the calling for Congress to adjust the budget and aid State governments, change the structure and mission of the central bank (or even to create one), provide financial assistance to distressed banks and financial firms, and change the laws for the treatment of bankrupt debtors. On the other hand, history also reveals change, as Congress has created agencies to which it has delegated authority. In times of crisis, Congress' initial reaction may be to exercise increased oversight, although Congress can and has changed the powers of agencies during financial crises.

Despite precautions, bad economic events are likely to happen again in the future. Congress can expect to be called to consider temporarily suspending, or even fundamentally changing, the economic rules of the game. So long as the Constitution grants Congress the authority to deal with fiscal policy, monetary policy, banking regulation, and bankruptcy, a financial crisis will most likely result in calls to revisit the normal rules of the game.

Historically, while Congress did not always make the same decisions in the financial crises discussed, Congress did deliberate similar issues. It is difficult to interpret congressional inaction for fiscal policy in the 1840s and monetary policy in the 1890s as inability to act, because Congress enacted other temporary measures (such

as bankruptcy laws) during the same crises. Similarly, it is difficult to interpret congressional action to assist financial institutions during the 1930s and the 2000s as Congress' hands being forced, because there were potential actions Congress declined during the same crises.

To the extent the past is a guide, one would expect people to petition Congress to use its powers to facilitate temporary changes to whatever rules are in place during the next economic crisis. Therefore, attempts by a current Congress to create a framework that would prevent a future Congress from having to deliberate on an unpopular financial rescue package during a future crisis is problematic. On the other hand, perceptions by market participants that Congress must act to save distressed firms may be frustrated, as illustrated by congressional defeat of the Johnson Plan during the 1840s, congressional defeat of the free silver movement during the 1890s, and congressional willingness to shut down the government in the 2000s. The express constitutional grant of authority to Congress over economic policy means that these issues are likely to be deliberated during a crisis no matter what the preexisting rules are, because people often want temporary changes to existing rules, but it does not commit Congress to either action or inaction during a crisis.